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ORIGINAL

March 1, 1996

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street, NW
Washington, DC 20554

Re: CC Docket No. 94-1; Price Cap Performance Review for Local Exchange Carriers

Dear Mr. Caton:

Enclosed herewith for filing are the original and four (4) copies of MCI Telecommunications Corporation's Reply Comments in the above-captioned proceedings.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Chris Frentrup

Chris Frentrup
Senior Regulatory Analyst
Federal Regulatory

Enclosure
CF

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20054

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In the Matter of	)	
	)	
Price Cap Performance Review	)	
for Local Exchange Carriers	)	CC Docket No. 94-1
	)	

REPLY COMMENTS

TABLE OF CONTENTS

EXECUTIVE SUMMARY

The Total Factor Productivity (TFP) studies filed by the parties vary widely in their estimates of productivity, and the Commission should therefore not base the productivity factor in the long-term price cap plan on a total company TFP methodology. However, the results of the TFP studies filed by AT&T and Ad Hoc are broadly consistent with Local Exchange Carrier (LEC) performance under price caps, and justify a productivity factor of at least 8.5 percent. If the Commission chooses to use the TFP methodology to compute a rolling average, it should use the methodology employed by AT&T and Ad Hoc, computing TFP based on interstate services only, using the Commission-mandated depreciation rates and the authorized rate of return as the cost of capital.

The Commission should not adopt LEC proposals to lower the productivity factor for companies that face competition. Finally, exogenous changes should be limited to those rule changes which move costs into or out of the interstate jurisdiction.

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REPLY COMMENTS

I. INTRODUCTION

MCI hereby submits its reply comments in the above-captioned docket.[1] The Fourth Further Notice requests comment on several major changes to the price cap regulatory system, e.g., use of a Total Factor Productivity (TFP) model[2] to compute a productivity factor (also called an X-factor) for use in the price cap formulas, and on alternative methods of determining the X-factor. The Commission also seeks comment on whether the sharing mechanism can be eliminated and on other aspects of the long-term price cap plan, including changes to the common line formula and exogenous cost rules. Taken together, these proposals amount to a wholesale revision of the Commission's price cap system governing interstate access.

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1 In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1; Fourth Further Notice of Proposed Rulemaking, FCC 95-406, released September 27, 1995 (Fourth Further Notice).

2 Total Factor Productivity is the ratio of an index of total outputs to an index of total inputs.

In response to these issues, several parties have submitted TFP studies. These studies yield vastly different estimates of Local Exchange Carrier (LEC) productivity. However, as discussed infra, the results of the studies by Ad Hoc and AT&T are consistent with the LECs' performance under price caps. The Commission should set the minimum X-factor to at least 8.5 percent, and require the LECs to make a one-time adjustment to remove the difference between 8.5 percent and the X-factor the LEC selected in the 1995 annual access filing from the LECs' Price Cap Indexes (PCIs).

II. BACKGROUND

In 1990, the Commission adopted mandatory price cap regulation for the Bell Operating Companies (BOCs) and GTE Operating Companies, and allowed other carriers to elect price cap regulation at their option.[3] In the LEC Price Cap Order, the Commission scheduled a performance review to evaluate the price cap system it adopted in that order. The Commission completed the first phase of the review in March 1995, adopting several interim revisions to the

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[3] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786(1990) (LEC Price Cap Order), recon, 6 FCC Rcd 2637 (1991), (LEC Price Cap Reconsideration Order), aff'd sub. nom., National Rural Telecom Assoc. V. FCC 988 F.2d. 174 (D.C. Cir. 1993). Those LECs that have elected price cap regulation are United and Central Telephone Companies, Rochester Telephone Corporation, The Lincoln Telephone and Telegraph Company, and Southern New England Telephone Company.

price cap plan.[4] Among those revisions were a 0.7 percentage points increase in the 3.3 percent minimum productivity factor, and optional productivity factors of 4.7 percent or 5.3 percent. The sharing and low-end adjustment rules were adjusted to change the amount of sharing associated with the productivity factors, including elimination of all sharing obligations if a company chose the 5.3 percent factor. The Commission also revised its exogenous cost rules, and changed the lower limits on price reductions for the service categories.

In the First Report and Order, the Commission concluded that for the long-term price cap plan it should replace the method of calculating the X-factor with a new method, which should be based on an industry-wide measure of performance and include changes in unit costs that occurred since the adoption of the price cap plan.[5] The Commission also made several tentative conclusions: (1) that the X-factor should be based on a moving average rather than fixed for a number of years;[6] (2) that the X-factor should be based on a TFP methodology;[7] (3) that the long term price cap plan should

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4 Price Cap Performance Review for Local Exchange Carriers, First Report and Order, 10 FCC Rcd 8962 (1995) (First Report and Order).

5 Id. at 9026.

6 Id.

7 Id.

have two or more X-factors.[8] The Commission established a goal of eliminating sharing,[9] and decided that if the long-term plan had multiple X-factors, at least one of those X-factors should have no sharing obligation.[10] The Commission also adopted changes in its exogenous cost rules,[11] but declined to revise the Common Line formula in the interim price cap plan.[12]

The Commission seeks comment on several features of its proposed changes to the price cap plan: (1) the X-factor, including the method of its calculation and whether it should be reviewed and modified periodically or set on a permanent basis; (2) the number of X-factors to be included and the sharing requirements, if any, which should be associated with those X-factors; (3) the common line formula; and (4) the exogenous cost rules.

III. THE COMMENTS DO NOT SUPPORT A TFP METHOD OR SELECTION OF A TFP-BASED X-FACTOR

In their comments, three parties submitted TFP-based studies of LEC productivity.[13] By making different assumptions about the various factors about which the Commission has sought comment, these studies computed

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8 Id. at 9035.

9 Id. at 9047.

10 Id. at 9049.

11 Id. at paras. 9090-2; 9097-9100; 9104-9107.

12 Id. at 9079-80.

13 AT&T Comments at 29; USTA Comments, Attachment A at v-vi; and ETI Report attached to Ad Hoc Comments, at 55.

achieved productivity levels without a Consumer Productivity Dividend (CPD) varying from 2.8 percent to 7.3 percent to 9.4 percent.

USTA has presented a simplified model, which is a modification of its originally submitted Christensen study. However, this simplified model has all of the problems that USTA's original study had, as detailed in MCI's initial comments.[14] USTA continues to compute its TFP measure on a total company basis, and uses what it claims are "economic" depreciation rates and cost of capital.

The Commission has stated that the X-factor it adopts in the long-term price cap plan should have three characteristics.[15] First, the X-factor should be economically meaningful, i.e., it should provide a reliable measure of the extent to which changes in LECs' unit costs have been less than changes in the price level in the economy as a whole. Second, the X-factor should ensure that LEC reductions in unit costs are passed through to consumers. Finally, calculation of the X-factor should be reasonably simple and based on accessible and verifiable data. MCI noted in its comments that USTA's original TFP studies failed on each of these three counts. USTA's simplified study also fails on these three counts.

As with its original studies, USTA's new TFP study does not provide a

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[14] MCI Comments at 5-11, 17-19.

[15] Fourth Further Notice at para. 16.

reliable measure of the extent to which changes in LECs' unit costs have been less than changes in the price level in the economy as a whole. After reviewing the record in this docket, the Commission determined that its initial choice of X-factor had been too low and that a higher X-factor was necessary to ensure that the LECs' rates remained reasonable. USTA's new TFP-based estimate of the X-factor is still substantially below the interim X-factors that the Commission adopted, and also well below the X-factors found by other parties in this proceeding. Thus, USTA's TFP study is not "economically meaningful."

In fact, the X-factor USTA computes in its simplified TFP study is still below even the Commission's initial choice of X-factor. The Commission has already found that its initial choice of X-factor failed adequately to reflect the LECs' achieved productivity. Thus, USTA's simplified TFP study also fails the second leg of the Commission's requirements, because it would fail to pass through to ratepayers the LECs' actual reductions in unit costs.

USTA's simplified TFP study also fails to meet the third requirement. In an attempt to provide publicly available sources for the data needed for its simplified study, USTA proposes a Tariff Review Plan (TRP) to be used to provide the data necessary to produce its version of a TFP study.[16] As an example of publicly available sources of data, Chart MISC-1 of USTA's TRP

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16 USTA Comments at Attachment B.

cites "USTA Comments" (for rows 500-600), and "Dale M. Jorgensen" (for rows 610-620). Previous submission on the public record of unverified and unverifiable data does not qualify as "publicly available" data. USTA's proposed simplified model fails the third leg of the Commission's requirements.

USTA argues against the use of the Commission's mandated depreciation rates rather than "economic" depreciation rates on two grounds; Commission-mandated depreciation rates require a burdensome data collection; and, the Commission may not be required to regulate depreciation rates under the Telecommunications Act of 1996. Any depreciation rates used in a TFP study will have to be examined by the Commission. MCI does not understand how "economic" depreciation rates can be developed with any less oversight by the Commission than the current depreciation rates. If the Commission adopts a TFP methodology for continually updating the productivity factor, it will have to "mandate" depreciation factors, regardless of whether the new legislation allows them to forebear doing so. In addition, as MCI showed in its initial comments in this proceeding, the current Commission-mandated depreciation rates do not greatly understate the LECs' "true" depreciation rates.[17] The existing depreciation rates are thus the correct rates to use in the TFP study.

USTA also argues that TFP is economically meaningful only if it is

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[17] See MCI Comments at Appendix A.

computed on a total company basis, because LEC interstate and intrastate services are largely provided over common facilities.[18] MCI has already presented its arguments against basing the X-factor for interstate rates on a measure of total company productivity; that the price cap system is capping interstate, not total company rates, and that LEC use of inputs may differ between the state and interstate jurisdiction. Those arguments are also reflected in other parties' comments.[19] In addition to those arguments, MCI notes that the starting rates for price caps reflected the Commission's allocation under rate of return regulation of the joint and common costs of the LECs. Use of a measure of total company productivity will not relieve the Commission of determining how to allocate those costs between the state and interstate jurisdictions; it will merely perpetuate the allocation that already exists.

AT&T's and Ad Hoc's productivity studies are also based on a TFP methodology. However, both these studies measure only interstate productivity, include an input price differential, and use the Commission's depreciation rates and cost of capital. Even given these similarity of approaches, these studies give productivity measures of 7.3 and 9.9 percent, respectively. This range of results confirms what MCI predicted in its

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[18] USTA Comments at 27-31.

[19] See, e.g., AT&T Comments at 13-18; Ad Hoc Comments at 5-7.

comments; TFP studies are not an exact science and cannot be made so. If the Commission chooses to perform TFP studies every year to update the X-factor, it will have to resolve many issues each year. This will consume resources both at the Commission and in the industry that could be better used elsewhere.

IV. LEC BEHAVIOR UNDER PRICE CAPS SUGGESTS AN INDUSTRY X-FACTOR OF 8.5 TO 11 PERCENT

Despite the problems with TFP studies outlined supra, the LECs' choice of productivity factors under price caps confirms the reasonableness of Ad Hoc's and AT&T's results. Figure 1 computes the LECs' expected rates of return under each of the Commission's current three X-factor options, given any one of several potential earnings levels, and then computes the X-factor the LEC would have to achieve to earn that rate of return.[20]

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[20] The table uses industry price cap revenue of $21.61849 billion and total industry Average Net Investment of $30.828507 billion, both from the LECs' 1994 Form 492As. It also conservatively assumes that the LECs pay only federal income tax at the rate of 34%. If the analysis also included state income tax, the X-factor at which the LECs would achieve the same earnings under 5.3% option would be even higher.

FIGURE 1
RATE OF RETURN AND PRODUCTIVITY LEVELS UNDER THE CURRENT PRICE CAP PLAN

Implicit X	ROR at X = 4%, no sharing	ROR at X = 4% after sharing	ROR at X = 4.7% after sharing	ROR at X = 5.3%
4.00%	11.25%	11.25%	10.93%	10.65%
5.08%	11.75%	11.75%	11.43%	11.15%
6.16%	12.25%	12.25%	11.93%	11.65%
7.24%	12.75%	12.50%	12.34%	12.15%
8.32%	13.25%	12.75%	12.59%	12.65%
8.54%	**13.35%**	**12.75%**	**12.64%**	**12.75%**
10.48%	14.25%	12.75%	13.09%	13.65%
11.56%	14.75%	12.75%	13.34%	14.15%
12.64%	15.25%	12.75%	13.59%	14.65%
13.72%	15.75%	12.75%	13.84%	15.15%
14.80%	16.25%	12.75%	14.09%	15.65%
15.88%	16.75%	12.75%	14.25%	16.15%
16.96%	17.25%	12.75%	14.25%	16.65%

Several interesting facts are evident in this table. First and foremost, the actual productivity level at which a LEC would elect an X-factor of 5.3 percent is 8.54 percent, i.e., any LEC that chose an X-factor of 5.3 percent must have expected to be able to achieve an X-factor of at least 8.54 percent or it would have been able to retain more of its earnings if it had chosen an X-factor of 4.0 percent.[21] Even those LECs who chose an X-factor of 4.0 percent could have

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[21] It will pay a LEC to choose the higher X-factor only if it can retain more of its earnings under the Commission's sharing rules. When a LEC chooses the higher X-factor, it reduces its revenue and thus its expected rate of return. Lowering its rates 1.3% reduces a LEC's rate of return by about 0.6%; thus, a LEC will have to be able to retain enough greater earnings under the sharing rules to at least make up for this initial reduction in earnings. Under the Commission's

expected their true productivity to be as high as 8.54 percent; it is only at productivity levels above that level that it pays a LEC to choose the higher X-factor.

Second, the earnings levels at which sharing occurs do not give LECs the incentive to choose the higher X-factors until the LEC's true productivity greatly exceeds the higher X-factor. For instance, the LEC has no incentive to choose 5.3 percent as its X-factor until its expected productivity is actually 8.54 percent. If the Commission wishes to retain sharing for at least one X-factor option, it needs to re-examine the sharing bands so that the LECs will have the incentive to choose the higher productivity factor when their expected productivity achieves that higher level.

Finally, expected rate of return for the middle X-factor option of 4.7 percent is never greater than the expected rate of return from one of the other two X-factor options. This is consistent with the LECs' behavior in the 1995 annual access filing, in which most of the LECs chose an X-factor of 5.3 percent, with the remainder choosing 4.0 percent. If the Commission wishes to retain three X-factor options, it must adjust the sharing levels on the options so that each option will actually be chosen over some range of productivity.

In summary, in the 1995 annual access filing most LECs chose X-factors

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current sharing rules, this does not occur until the LEC would earn more than 12.75%, which implies the LEC achieved productivity of 8.54%.

which imply that they expected their productivity to be at least 8.54 percent. Figure 2 presents a similar analysis for the Commission's previous price cap plan, showing that the break-even productivity level under that plan was 7.45 percent. Because the LECs in general chose the lower productivity factor, this implies they expected their productivity gain to be no more than 7.45 percent. At first glance this seems inconsistent with the findings in Figure 1, which found that the LECs expected productivity to be at least 8.54 percent. However, under the previous price cap plan, the Commission had not mandated add-back of LEC sharing amounts. Thus, the LECs would have been making their computations of expected earnings based on earnings that were depressed by the absence of add-back. For 1994, the LECs returned almost $500 million in sharing; had this amount been added back, the LECs expected earnings would have risen about 1.6 percentage points. In that case, the LECs' expected earnings would have been about 14.8 percent, with an implicit X-factor of almost 11 percent. Thus, the fact that LECs in general chose the lower X-factor under the former price cap plan implies that they expected that their productivity would be no greater than about 11 percent.

FIGURE 2
RATE OF RETURN AND PRODUCTIVITY LEVELS UNDER THE ORIGINAL PRICE CAP PLAN

Implicit X	ROR at X = 3.3%, no sharing	ROR at X = 3.3% after sharing	ROR at X = 4.3% after sharing
3.30%	11.25%	11.25%	10.79%
4.38%	11.75%	11.75%	11.29%
5.46%	12.25%	12.25%	11.79%
6.00%	12.50%	12.38%	12.04%
7.45%	13.17%	12.71%	12.71%
7.62%	13.25%	12.75%	12.79%
8.70%	13.75%	13.00%	13.27%
9.78%	14.25%	13.25%	13.52%
10.86%	14.75%	13.50%	13.77%
11.94%	15.25%	13.75%	14.02%
13.02%	15.75%	14.00%	14.27%
14.10%	16.25%	14.25%	14.52%
14.75%	16.55%	14.25%	14.67%
15.18%	16.75%	14.25%	14.77%
16.26%	17.25%	14.25%	15.02%

Taken together, the LECs' behavior under the previous and current Commission price cap plans imply that the LECs have expected their productivity to fall between 8.5 and 11 percent. This information provided by the LECs has occurred in a situation in which the LECs' money was at stake, rather than in pleadings at the Commission in which they have an incentive to make the productivity level they can achieve appear low. An X-factor between 8.5 and 11 percent would allow the LECs' earnings to remain at 11.25 percent, and would ensure that ratepayers received the benefits of the LECs' achievable cost reductions.

If the Commission wishes to adopt a TFP rolling average methodology for use in updating the X-factor in the long-term price cap plan, it should perform those studies using the methodology employed by Ad Hoc and AT&T, including performing the study on an interstate-only basis and using the Commission-approved depreciation rates and authorized rate of return. That methodology both gives results consistent with the LECs' behavior under price caps and is reasonable on theoretical, legal, and public policy grounds.

V. LEC ACCESS RATES ARE CURRENTLY WELL ABOVE ECONOMIC COST

As MCI noted in its comments, the Commission originally adopted price cap regulation for the LECs because it believed doing so would, inter alia, more closely mirror the efficiency incentives found in competitive markets.[22] Noting that rates produced under rate of return can be uneconomically high, the Commission stated that price cap regulation would force carriers to be more productive than they were under rate of return regulation, and that any inefficiencies embodied in the starting point price cap rates would be eliminated over time, as the LECs improved their productivity due to the incentives under price cap regulation.[23]

The efficiency incentives in a competitive market drive rates toward economic costs. A properly functioning price cap plan should do the same.

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22 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786, 6790 (1990) (LEC Price Cap Order).

23 Id. at 6816.

However, as MCI noted in its previous comments, there is substantial evidence that the LECs' access rates are currently well above economic cost.[24] For example, when the Commission revised the local transport rate structure, it required the LECs to set their switched access trunking rates equal to their special access trunking rates, with the difference between the previously existing switched transport rates and the new rates recovered in an Interconnection Charge. That Interconnection Charge recovers approximately 70 percent of the previous switched transport rates. Similarly, the Benchmark Cost Model filed in the Universal Service Fund docket shows that current LEC local service rates in most cases recover most, if not all of the entire economic cost of providing the local loop.

The LECs' current access rates are currently well above economic cost. The Commission has before it ample record evidence, with LEC behavior to support that evidence, that the LECs have been able to achieve productivity levels between 8.5 and 11 percent. Given the LECs' demonstrated ability to achieve high productivity levels, the Commission need no longer be so conservative in its choice of X-factors. Doing so has not served ratepayers well in the past, and will allow the LECs to maintain unreasonably high access charges.

The Commission should adopt an X-factor of at least 8.5 percent. This

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24 See MCI Comments at 12-13.

X-factor should continue to have a sharing obligation. The Commission should set only one higher X-factor, of at least 11 percent, which can have no sharing obligation. However, the Commission must design the sharing bands for the lower X-factor so that the LEC will have proper incentives to select an X-factor that closely matches its true productivity. Setting X-factors at these levels would be consistent with both the LECs' achieved productivity and the measures of interstate TFP on the record.

VI. DEVELOPMENT OF COMPETITION DOES NOT JUSTIFY A LOWER X-FACTOR

NYNEX argues in its comments that the productivity factors should be reduced by 25 percent when a market is open to entry, and by 40 percent when there is significant competitive presence.[25] NYNEX argues that productivity will fall as competition develops, because output will fall and such LEC expenses as marketing will go up.[26]

As MCI stated in its comments, it is ludicrous to believe that productivity will fall as competition grows. Even if output falls as competition develops -- and this proposition seems unlikely, given the experience in the interexchange market -- no company will respond to that by failing to cut its costs. If inputs are reduced by as much as outputs fall, productivity will remain constant. In

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25 NYNEX Comments at 11. Pacific also claims it needs a lower X-factor due to the presence of competition. See Pacific Comments at 6-8.

26 NYNEX Comments at 5.

reality, the LECs will have to become more productive as competition increases.

In a competitive market, if a more efficient new entrant enters, the incumbent firms all suffer reduced earnings until they learn how to become as efficient as the new entrant. Any LEC who faces a lower cost new entrant should face the same market discipline as any competitive firm. The Commission should not lower the productivity factor when competition occurs. Once competition is strong enough to constrain LEC pricing, the caps can be removed altogether; they should not be reduced when competition occurs.

NYNEX's request is also inconsistent with the requests for additional downward flexibility the LECs have made. What NYNEX wishes to do is to be able to have added downward flexibility for the services for which it faces the most competition, while having greater upward flexibility for its rates overall, so it can insure itself against the more targeted rate decreases it wishes to make. The Commission should not allow this to occur.

VII. EXOGENOUS COSTS SHOULD BE LIMITED TO CHANGES THAT CAUSE JURISDICTIONAL SHIFTS, AND MUST BE REFLECTED SEPARATELY IN THE PRICE CAP FORMULAS

As MCI has previously argued, exogenous cost changes should be limited to only those changes which cause a shift of costs into or out of the interstate jurisdiction, or when changes are made to the rules dividing costs between the regulated or non-regulated sectors. Those parties opposing this proposal do so on the grounds that limiting exogenous changes "serves no

legitimate purpose."[27] To the contrary, limiting exogenous changes in this way would simplify the administration of exogenous changes and require the LECs to face the same decisions competitive companies face; how to adjust to changes in costs when their ability to change prices is limited. The "legitimate purpose" served by allowing exogenous treatment of changes to the allocation of costs to the interstate jurisdiction is the legal and policy necessity for creating a mechanism that recognizes such cost changes. Without such an exogenous cost rule, decisions to shift revenues into or out of the interstate jurisdiction could not be implemented.

VIII. CONCLUSION

LEC access rates are well in excess of economic costs. For the reasons stated herein, the Commission should increase the X-factor to a minimum of 8.5 percent, retaining a sharing mechanism for that X-factor. The Commission should not adopt a TFP methodology to update the X-factor annually, because doing so would consume scarce Commission and industry resources unnecessarily. If the Commission nevertheless uses the TFP methodology to compute a rolling average, it should compute TFP based on interstate services only, using the Commission-mandated depreciation rates and the authorized rate of return as the cost of capital. The Commission should not reduce the X-factor of LECs that face competition, because doing so would shield the LEC

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[27] USTA Comments at 46-47.

from the market discipline the competition can bring. Finally the Commission should limit exogenous changes to those rule changes which move costs into or out of the interstate jurisdiction.

Respectfully submitted,
MCI TELECOMMUNICATIONS CORPORATION

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Dated: March 1, 1996

STATEMENT OF VERIFICATION

I have read the foregoing and, to the best of my knowledge, information, and belief, there is good ground to support it, and it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on March 1, 1996.

Chris Frentrup

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CERTIFICATE OF SERVICE

I, Stan Miller, do hereby certify that copies of the foregoing Reply Comments on were sent via first class mail, postage paid, to the following on this 1st day of March 1996.

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